

RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

PO Box 1759, La Jolla, California 92038

SINCE 1958

17 Letters Per Year - \$250 Annually

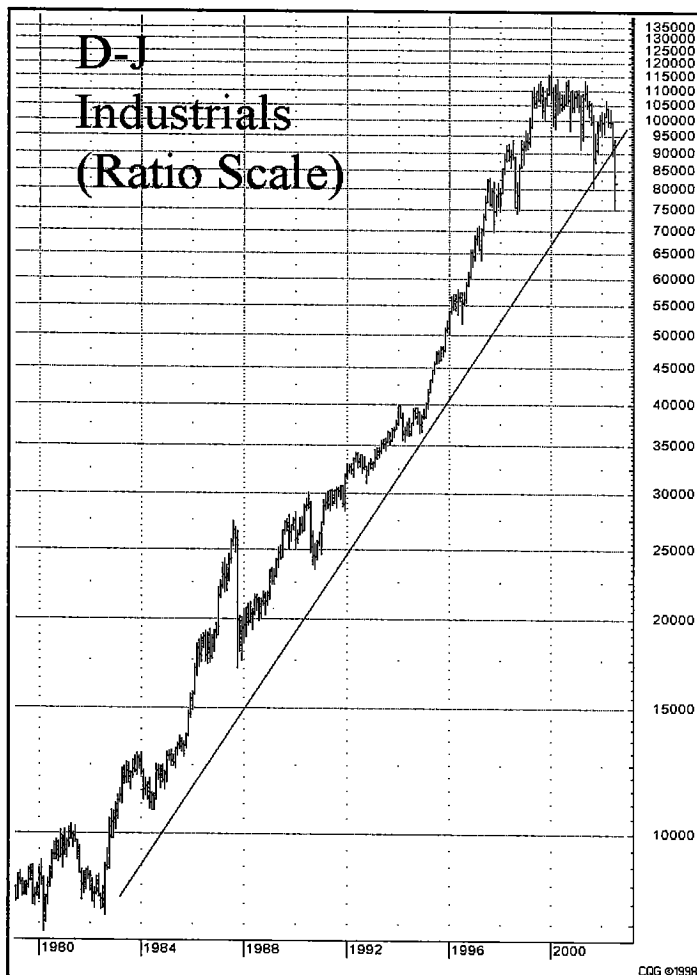
LETTER 1339

July 31, 2002

BIG PICTURES – This is going to be an unusual Dow Theory Letter because it's going to include a lot of charts. The first two charts deal with the monthly Dow drawn to two scales, a ratio chart and an arithmetic chart.

July 12, DJIA 8684.50; PTI 5237; A-D Ratio -1.05
July 19, DJIA 8019.26; PTI 5284; A-D Ratio -2.56
July 26, DJIA 8264.39; PTI 5220; A-D Ratio -3.82
S&P Yield: 36.4 S&P p/e: 1.72
Gold 50-Day MA: 318.80

The first chart shows the entire 1982 to 2000 bull market in the Dow on ratio scale. Ratio scale shows the Dow in percentages. On a ratio chart, a rise from 150 to 300 takes up the same vertical distance as a rise from 500 to 1000 or from 750 to 1500. In other words, each of these represents a 100% gain, and thus they are shown correctly on the chart (after all, when buying or selling stocks we are dealing in percentages of gain or loss).

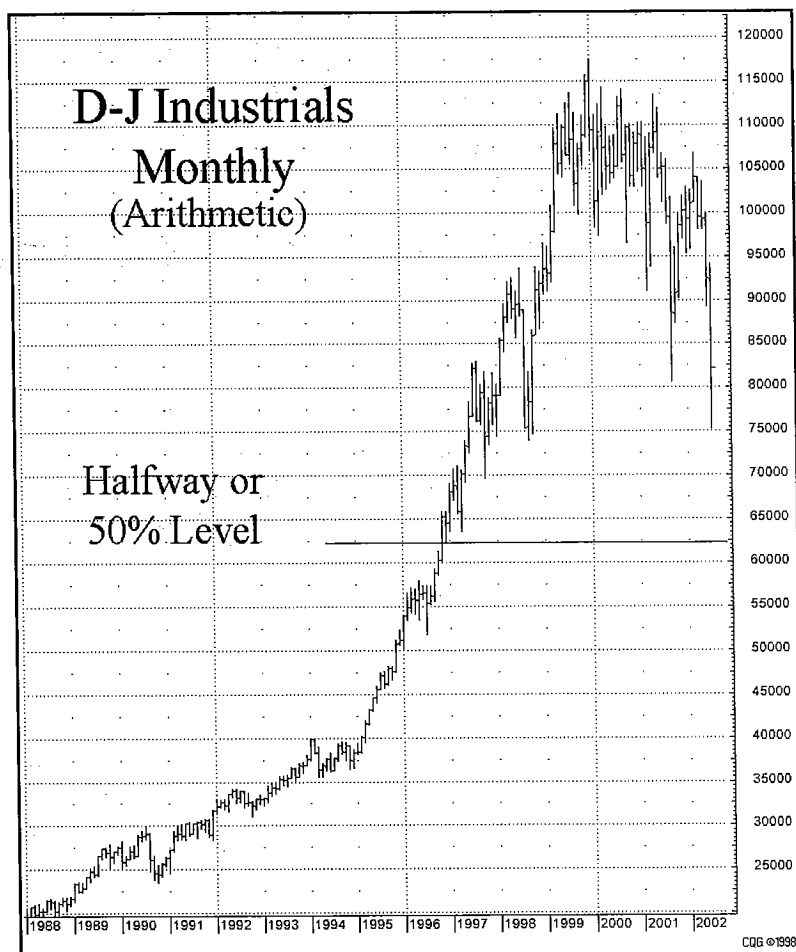


On ratio scale the Dow has been rising above an amazingly long upward trendline. This trendline depicts rate of growth, and as long as the Dow holds above this trendline, the Dow is maintaining a steady rate of growth.

But look at what's happened. The rising trendline was violated twice in recent months. Then in the month of July, for the first time in 18 years, we saw a full month in which the Dow held entirely below the rising trendline.

This tells us that the rate of growth of the last 20 years has been reversed. This is an important consideration and confirmation that the bull market has ended and that a bear market has started. This chart also suggests how far the Dow could fall before this bear market ends.

The second chart (top of page 2) is drawn to **arithmetic** scale. I include this chart because it gives us a different concept of distance. I have also drawn a horizontal line showing where the halfway or 50% level of the entire bull market comes in.



The 50% level comes in at 6244. It will be very important to see whether, on advances and declines, the Dow can remain above the 6244 level, or whether the Dow will sink below the 6244 level as the bear market moves on.

If the Dow on all future movements can remain above 6244, I would call this very encouraging action. However, if the Dow breaks below 6244 and if future action tends to stay below 6244, I would call this type of action – ominous.

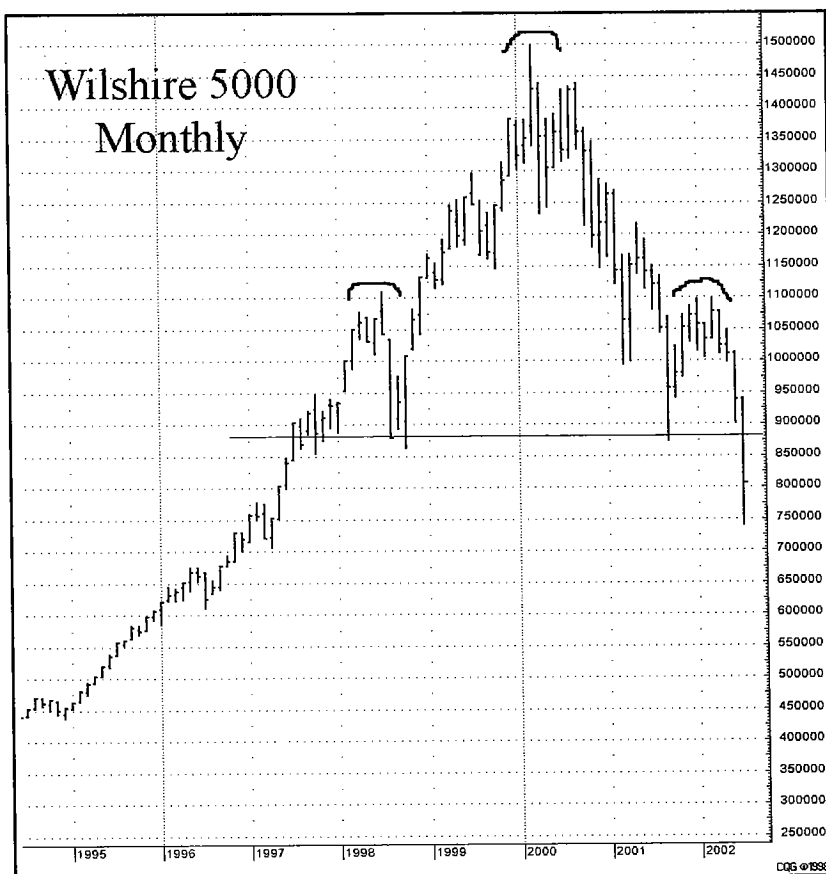
A Dow that remains persistently below 6244 would call for much lower prices. In that case I would give credence to a Robert Prechter prediction. Robert predicted that the Dow, which was five digits at its highs, would return to being a three-digit average. In case you didn't take that in, a three-digit Dow would be a Dow below 999. A deeper analysis of this subject appears on page 4 of this Letter. (Prechter, *Elliott Wave International* 800-336-1618).

The next monthly chart shows the very broad Wilshire 5000 average (actually, about 6,500 stocks). This average takes in almost all the listed stocks on the NYSE, the Nasdaq and the Amex.

The formation we see here is typical of the S&P, the NYSE Composite and the D-J Composite. What we see here on the monthly chart is a perfectly symmetrical "head-and-shoulders" top pattern. I have drawn a horizontal line depicting the "neckline" or the level of support.

In July, that support was violated on all the leading stock averages listed above. The authority of the break below support was confirmed by the surge in volume as the support was violated.

These are the largest tops I have ever seen in a stock average. They are telling me that this bear market has a lot of distance to go on the downside. After all, the violation of the support lines on these major



averages has just occurred here in July. Could the bear market be over on the same month that supports have been violated? Hardly.

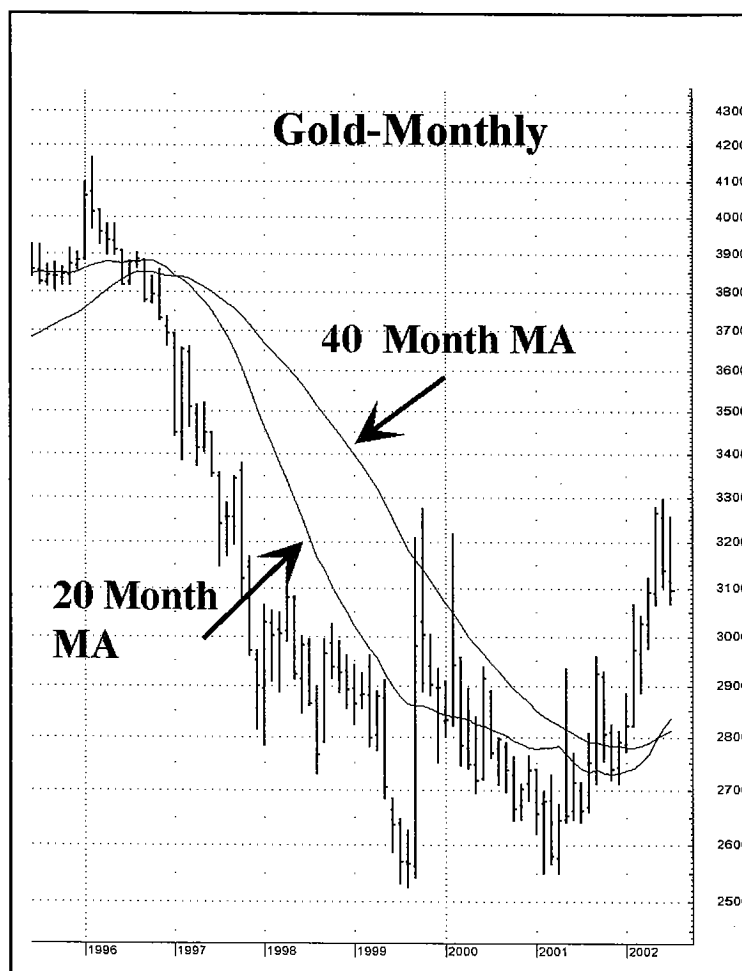
GOLD - In order to provide perspective, I am showing a monthly chart of gold along with a 20-month and a 40-month moving average. The low or the bottom of the bear market for gold came in August 1999 at which time gold sank to 252. Next came a huge rally to an October 1999 high of 327. A second vicious decline took gold to a low of 255 in February of 2001.

From there gold rallied to a high of 329 in June 2002. In July gold backed off to a low of 306.

In the meantime, note that for the first time since 1996 the 20-month moving average of gold has crossed above the 40-month moving average. This occurred two months ago in May. I took the crossing of the moving averages along with the formation in gold as identifying a new bull market in the yellow metal.

I don't know how the gold bull market is going to progress or work out. It's easy to see how gold could correct the most recent rise from 255 to 330. The downside crossing of the two moving averages was followed by a six-year bear market. Therefore, it would not surprise me to see a coming six-year (or maybe more) bull market in gold.

Those who hold gold will have to be patient. As the monthly chart implies, the gold bull market should be a long one. In fact, this could be just the beginning.



DEBT and DEFLATION — I've been talking rather incessantly about the Fed's desperate battle to ward off the global forces of deflation. How do you ward off deflation? You do it with lower interest rates, by blowing up the money supply, by talking up the money supply. In a word, you try to defeat deflation by re-inflating.

Why so much worry about deflation? In a conservative society, deflation is no great threat. People "pull in their horns," they cut back on their spending, they turn very conservative and they do what they have to do — to survive. We saw that during the Great Depression. My family survived the Great Depression. Most families did. It wasn't easy. But we did it, we survived.

Japan has been battling deflation for years. And the fact is that most Japanese families didn't find it too difficult to function in a deflationary atmosphere. The reason the Japanese weren't too hurt by deflation is that the Japanese are great savers. The Japanese are probably the most frugal and most successful savers in the world.

Not so the US consumer. Americans are expert spenders. They spend their heads off, and if they run out of money, well they put a second mortgage on their home, and they spend the newfound money. Private debt in the US is estimated to be \$32 trillion. At the same time, total government debt is around \$6 trillion. This comes out to around \$104 thousand of debt for every man, woman and child in the US. To put it briefly, this nation is up to its eyeballs in debt.

What Greenspan knows is that if the US sinks into deflation, it will be impossible to even service the debt. If the US sinks into deflation, we'll see bankruptcies by the thousands in every area of the US. For this reason, the Fed is doing everything in its power to avoid deflation and to stimulate the forces of inflation. I believe that this is the unspoken battle that the Fed is now engaged in. And the BIG question is – is the Fed being successful in winning the battle to re-inflate the US economy?

Deflation plays hell with debt. Deflation makes it harder to collect dollars, and in deflation dollars tend to be worth more. You can cut back on your spending, you can cut back on your business expenses, you can do a lot of things – but no matter what you do — **THE DEBT REMAINS**. You can pay off debt, you can declare bankruptcy and rearrange your debt, or you can go broke and eliminate your debt. But one way or the other, debt must be dealt with.

S&P WIPE OUT - The following study has very important implications, and very frankly I'm still pondering the full meaning of this study. The bull market for the S&P Composite started in 1982 at 103. The bull market lasted for 18 years, topping in the year 2000 at 1527. Thus, this great bull market added 1424 points to the S&P. The halfway level of the entire bull market in the S&P was 815.

As I write, the S&P is priced at 793. This means that the S&P as of yesterday had wiped out over 50% of its entire 1982-2000 bull market. I take this performance as very bearish. As of yesterday, the S&P had failed to retain even half of its bull market gains. In my opinion, the S&P at 815 is now a very important level — it's the halfway level of the entire 18-year bull market in the S & P. The comparable level for the Dow is 6244. The Dow remains well above that level.

The studies above are what I term “the very big picture.” To my mind, these studies will ultimately be the most important consideration for investors and for the nation. I'll keep subscribers informed of how this all works out as we go along. Remember, these are very long term studies.

DOW'S 50% PRINCIPLE: Not one in 10,000 investors knows what I'm going to say. But believe me, the following is vitally important. I've talked about Dow's 50% principle before, but for the benefit of newer subscribers, I want to go over this little-understood principle again.

I first learned about the 50% principle from George Schaefer, the great Dow Theorist who wrote his reports during 1948-1974. **Schaefer had studied how the Dow works carefully. Schaefer noted that Dow was particularly interested in what the Industrial Average did at the halfway or 50 % level of previous major advances or declines.**

Note that I said “major” advances or declines. The principle should not be applied to minor moves of 50 or 100 Dow points which take place over a period of a few weeks or so. The **larger and longer** and more important the market move (up or down), the more valid the 50% principle when it is applied correctly.

Schaefer likened the 50% Principle to the action of a child's seesaw. When the child pushes up his end of the seesaw, if he pushes up with enough force his end will rise to the high. But if he pushes up, and his push lacks the necessary momentum, his end will approach the horizontal, stall — and will then sink back to the ground again.

The market can act in much the same way. The most recent example of the 50% Principle that I use worked as follows: the

Dow hit a record high of 11722 in January of 2000. After a complex series of advances and declines, the Dow finally broke to a low of 8235 on September 21, 2001. That represented a decline from high to low of 3487 points over a period of 19 months – and it certainly qualified as a major movement (to the downside).

The halfway or 50% level of the entire decline from Dow 11722 to Dow 8235 was **9978**. For months the Dow attempted to establish itself above the halfway or 9978 level. Finally, after repeated efforts failed to keep the Dow above 9978, on April 26 the Dow plunged decisively below the 9978 level. The repeated efforts to hold above 9978 seemed to have exhausted the Dow. Once sinking decisively below 9978, the Dow literally collapsed, and on July 19 the Dow smashed below the 8235 level of last September, thereby living up to the “forecast” of the 50% Principle.

What next for the 50% Principle, now that the Dow has broken below the September low? Here’s what the 50% Principle is saying next. The great bull market started in 1982 at 776 on the Dow. The bull market topped out for the Dow in January 2000 at 11722. Thus, the Dow between 1982 and 2000 climbed 10946 points. The halfway or 50% level of the entire 1982-2000 bull market is 6249.

I believe this bear market will take the form of an A-B-C, with A the first major leg down, B a major upside correction and C the final major down-leg which will complete the bear market. By my calculation, we are still in the “A” leg, which, of course, is the initial major bear leg of this primary bear market.

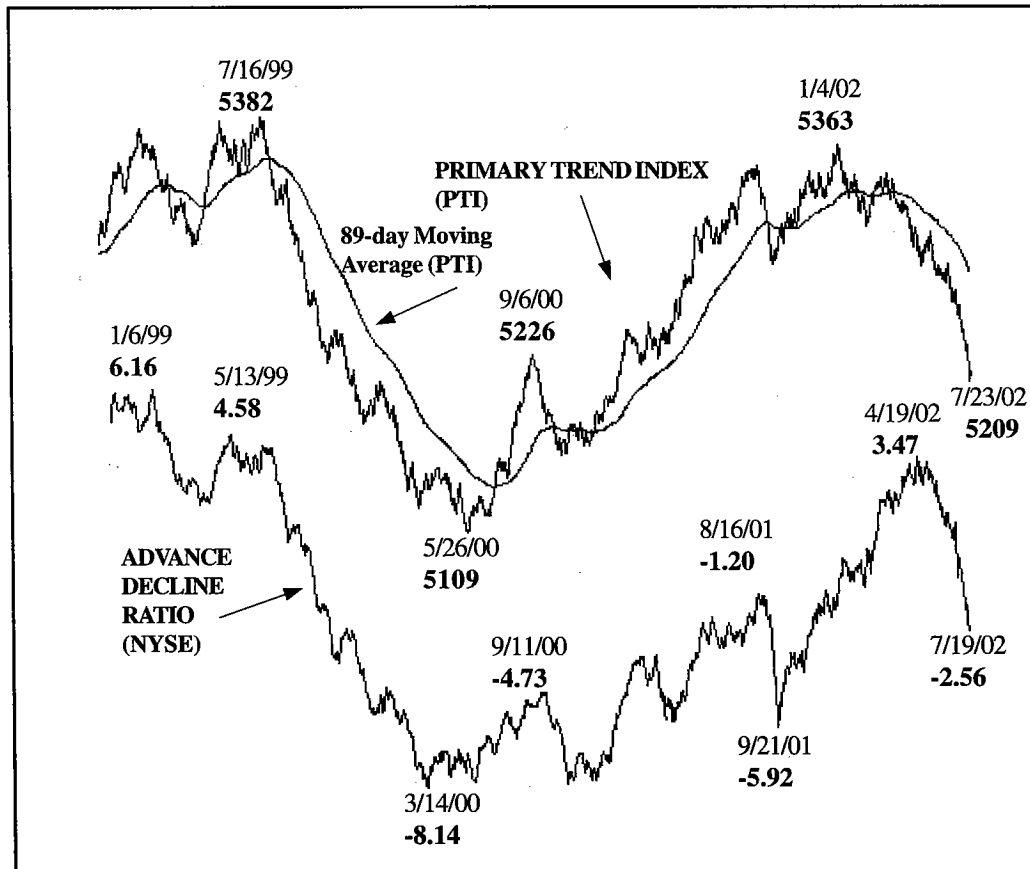
The important process to watch now is whether on any decline the Dow will break below 6249. Frankly, I would be surprised if this “A” leg goes so far as to take the Dow below the halfway level of 6249 (of course, the market can do anything, and anything is possible).

If I had to guess, however, I’d guess that this “A” will carve out an important low somewhere above 6249. Furthermore,

the “A” leg should hit bottom somewhere between now and September-October and at worst in November. From that important low, the Dow should embark on the “B” leg, which should be a major corrective leg taking the Dow to a high somewhere during 2003.

Question – Russell, if or when this “A” of the bear market is completed, will you suggest that we step in and buy stocks or options or futures for the major advance that you believe lies ahead?

Answer – I will certainly attempt to identify the point at which the “B” leg of the bear market begins. At that point I



very well may suggest that subscribers, if they are so inclined, take limited positions in options or such items as SPYs and DIAs and QQQs.



INVESTMENT POSITION – At this point, I believe the ideal position would be 95% in T-bills and 5% in gold items and maybe even in physical gold. This is about as conservative a position as you can get into. It's an extreme position, to be sure, and one that I doubt many subscribers are in.

I call this the "rich man's position" because there's almost no yield in this position, meaning only the rich can afford it. But as I've often said, the first consideration of wealthy individuals is conservation of capital, and this position equals conservation of capital.

I want to emphasize the battle the Fed is waging against the forces of deflation. The great fear of the Fed is that the US is following the path of Japan into net deflation. As a matter of interest, Japan's price index has declined for 33 consecutive months. And this week Japan's Nikkei stock average, which has been holding above 10,000 since February, broke sharply below 10,000.

So far, US consumers continue to be very complacent about the stock market. It's as if they're staring, transfixed as their assets go down the drain. The reason for consumer complacency, I believe, is the surge in home prices, better known as "the housing bubble." I believe the KEY to the future of inflation or deflation in the US is the price of homes. The median price of homes in the US is now about 20% above the median of 2001. In some areas, it is even higher.

The Fed is desperate to keep the housing boom going. The Fed knows that if the US lapses into net deflation as per Japan, it would be a disaster and bankruptcies would head for the skies.

So two areas, in my opinion, will rule the US economy in coming months. The two areas are the stock market and home prices. What we're seeing now is the Fed in an all-out battle to keep these two areas from unraveling. It's "inflate or die" as far as the Fed is concerned.

The latest Gallup Poll shows that Americans are beginning to feel the economic pinch. Two years ago the Poll showed that 23% of Americans said they were "worse off financially than they were the previous year." The latest poll shows that percentage rising to 45%, its highest level in a decade.

This feeling of "economic pinch" I believe, will spread with the bear market, but as I said, the real disaster will come if the housing bubble finally bursts. We know, in the case of Japan, that its housing bubble burst well after the time when its stock market topped out. As an aside, Hong Kong is now seeing its housing bubble bursting with housing prices heading south in a vicious decline.

LATE NOTES – Is this it? Is this the long-awaited rally following the long-awaited "capitulation"? It isn't the rally I've been predicting, mainly because I didn't see enough indications of a major, sold-out bottom. But there were enough indications to get a rally going, and that's what Wall Street has been praying for.

It still bothers me a lot that we never, on the entire decline since last March, had a single 90% downside day. So maybe "it will be different this time." Personally, I'm not willing to bet on a "different" bottom, so I'll sit tight through this rally or whatever it is. But that's just me.

Next Mailing: August 21, 2002